HUNTON& WILLIAMS

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N.J. Appeals Court Says D&O Policy's Pollution Exclusion Does Not Bar Coverage For Securities Fraud Suit Alleging Misrepresentation Concerning Asbestos Claims

The Superior Court of New Jersey, Appellate Division, in an unpublished decision, has ruled that the pollution exclusion in a directors and officers insurance policy does not bar coverage for defense costs and damages arising from an underlying suit alleging securities misrepresentations regarding contingent liabilities for pollution claims. The court reasoned that the relationship between the alleged pollution and damages caused by the alleged misrepresentations was too attenuated to trigger the exclusion. *Sealed Air Corp. v. Royal Indemnity Co.*, No. A-5951-06T3, N.J. Super., App. Div, Aug. 15, 2008.

Background

W.R. Grace & Co. ("Old Grace") had accrued contingent liabilities due to alleged pollution. Old Grace formed a subsidiary called Grace Specialty Chemicals ("New Grace"), which was later spun off to become an independent company. Through a series of corporate transactions, Old Grace reorganized and merged with Sealed Air Corporation ("Sealed Air"), the insured. An independent auditor allegedly inadequately quantified and evaluated the amount of contingent liabilities to be assumed by New Grace. Old Grace had allegedly procured a moratorium on filing new actions with seventeen law firms who historically had filed asbestos-related litigation on behalf of plaintiffs, and this moratorium colored the auditor's report.

After the merger, Sealed Air's directors and officers made representations in SEC filings and press releases that Sealed Air would not incur any pollution liabilities. As a result of new asbestos-related lawsuits, however, New Grace was forced into Chapter 11 reorganization. A creditors' committee filed a claim alleging that the asbestos-related contingent liabilities were inadequately quantified, resulting in a fraudulent transfer during the transactions that led to the formation of Sealed Air. A federal court overseeing the bankruptcy proceedings held that New Grace's solvency at the time it was spun off from Old Grace should have been determined based upon the reality of the companies' existing liability and the inherent difficulty in defining that liability's scope, not on estimates of potential future liabilities. Therefore, the federal court ruled that asbestos claims filed after the spin-off of New Grace could be considered in determining its solvency. As a result of that ruling, Sealed Air's assets were potentially threatened, and the value of Sealed Air's stock dropped. Shareholders of publicly purchased Sealed Air securities brought a class action against Sealed Air for the alleged misrepresentations by its directors and officers. Sealed Air in turn filed a claim against its D&O insurer, seeking coverage for defense costs

and damages arising from the securities misrepresentation suit. The insurer denied coverage, relying on the pollution exclusion provisions in its policy. Sealed Air sued the insurer and the trial court found coverage. The insurer appealed.

The Decision of the Appellate Division

The pollution exclusion barred coverage for claims "based on, arising out of, or involving the actual, alleged, or threatened discharge, release, escape, seepage, migration, or disposal of asbestos and asbestos product." On appeal, the insurer argued that the policy's pollution exclusion was clear and unambiguous and should be literally read to preclude coverage for the claims by Sealed Air's securities holders because those claims were based on, arose out of, or involved Sealed Air's asbestos liability. The court found that the exclusion did not apply because the "gravamen of the securities holders' complaint has its root in securities fraud and misrepresentation, not pollution."

The Appellate Division reasoned that the claim was "based on" alleged securities fraud, not pollution, because, without the numerous intervening events and, ultimately, the alleged securities fraud, there would have been no damages that could be alleged by the securities holders. The court found that the phrase "arising out of" was ambiguous and was to be construed to comport with the insured's objectively reasonable expectation of coverage. The court explained that it was reasonable for Sealed Air to expect coverage for claims arising from damages allegedly suffered as a result of a securities litigation claim. The claim did not "arise out of" pollution because there was no substantial nexus between the pollution and the alleged securities holders' damages given the numerous intervening events. Interpreting the phrase "in any way involving" in the context of the pollution exclusion clause, the court read the phrase together with the surrounding words "based on" and "arising out of" to require "a more direct causal relationship between the pollution and the harm." Under this interpretation, "in any way involving" included only events that were not unreasonably attenuated from pollution. The Appellate Division concluded that the alleged pollution at issue was too attenuated from the damages arising from the alleged misrepresentations to trigger the pollution exclusion.

Affirming the trial court, the Appellate Division ruled that the underlying complaint arose from alleged securities violations, and not pollution, and the plain and ordinary language of the policy, as well as the reasonable expectations of the insured, prevented the insurer from disclaiming coverage based upon the pollution exclusion.

Implications

The New Jersey appeals court ruled that suits alleging securities misrepresentations will not be excluded by a pollution exclusion in a D&O insurance even though the exposures leading to the alleged damages resulting from the misrepresentation initially arise out of pollution. It is, under the court's reasoning, the nature of the alleged damage to the claimants, not the nature of the injury that might underlie that damage, that determines whether the exclusion applies. This reasoning has far-reaching implications, and signifies the need for some substantial causal nexus between the cause of an injury and the object of a policy-based exclusion. A distant or attenuated relationship will not suffice.